BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DAVID WAYNE DOMINICI)

For Appellant: Howard Hertz
Attorney at Law

For Respondent: Philip M. Farley
Counsel

O P I N I O N

This appeal is made pursuant to section 18646 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the petition of David Wayne Dominici for reassessment of a jeopardy assessment of personal income tax in the amount of $15,682 for the period January 1, 1981, through October 31, 1981.

Appeal of David Wayne Dominici

The issues in this appeal are whether appellant received income from the illegal sale of narcotics and, if he did, whether respondent properly reconstructed the amount of that income.

On October 29, 1981, Deputy Sheriff Patrick J. Mullen of the Alameda County Sheriff's Department, Narcotics Investigation Unit, received information from a confidential reliable informant (CRI) that David Wayne Dominici, who resided at 20898 Locust Street, Hayward, California, was in possession of cocaine. The CRI further stated he had overheard appellant state that the cocaine was for sale for $110 per gram.

The CRI had previously provided Deputy Mullen with reliable information which had resulted in the seizure of marijuana, cocaine, and hashish on three separate occasions, and one arrest, None of the information attributed to this CRI had ever been found to be false.

As a result of the above information, the police secured a warrant to /search appellant and his residence.

On October 30, 19811, Deputy Mullen and officers of surrounding police departments, armed with a search warrant, stopped appellant who was driving on Foothill Boulevard in Hayward. They served the search warrant and searched appellant, whereupon they found a vial containing between 1/4 and 1/2 gram of cocaine. Appellant accompanied the officers to /his Locust Street residence and a further search was conducted. Various items were seized at the residence including: (1) 3.9 ounces of cocaine, (2) 188.6 grams (6.16 ounces) of marijuana Thai-Sticks, (3) 4.7 ounces of hashish, (4) 1 1/2 to 2 pounds of marijuana, 1/2 pound of which was determined to be high grade sensimilla, (5) a/ gram scale, (6) barbiturates, (7) appellant's wallet containing what appeared to be drug sales records, and (8) $4,580 in cash.

Deputy H. D. Hoig of the Alameda County Sheriff's Narcotics Investigation Unit confirmed that the records found in appellant's wallet, and corroborated by the CRI to belong to appellant, were in fact narcotics sales records with the decimal point moved to conceal the true cash amounts.

Based upon the above information, respondent determined that appellant's narcotics sales had resulted in taxable income for the period January 1, 1981, through

October 30, 1981. It was further determined that the collection of tax would be jeopardized in whole or in part by delay. Respondent estimated appellant's taxable income to be $361,915.50, based solely on the amounts contained in appellant's sales ledger, after allowing a deduction of 50 percent for cost of goods sold. Accordingly, a jeopardy assessment was issued on November 2, 1981, for the above taxable period reflecting a net tax liability of $38,626. Two "Orders to Withhold" were issued: the first was served on the Alameda County Sheriff's Office, the second on the Wells Fargo Bank in Hayward. The amount of $4,580 was recovered from the sheriff's office, and $164.10 from the bank. The $4,580 was ultimately returned to appellant.

Prior to the hearing on appellant's petition for reassessment on November 2, 1982,[1/] appellant refused to complete a financial statement and questionnaire or provide any other form of written financial information. At the hearing, appellant's attorney stated that appellant kept no records other than the "ledger" sheets seized at the time of his arrest. According to appellant, some of. the figures on the sheets are actually subtotals of a series of sales to a buyer or are purchases of drugs for resale.

At the hearing, appellant also stated, through his attorney, that he had been selling approximately three pounds of marijuana a month for approximately nine months prior to his arrest (commencing in approximately February 1981) and had been selling three to four ounces of cocaine a month for approximately five months. The marijuana was purchased for $800 to $1,200 per pound and sold for approximately $1,600 to $2,400 per pound. The cocaine sold for approximately $110 per gram and had a 25% markup from its purchase price of $80 per gram. Appellant estimated his net income was approximately $48,000 for the nine months of his narcotics operation.

Subsequent to the petition for reassessment. hearing, respondent's hearing officer adjusted appellant's income. The facts used in the final adjustment of the jeopardy assessment were based on the admissions

1/ In the interim period between the date of his arrest and the petition for reassessment hearing, several actions regarding the seizure of appellant's property took place, which are not relevant to this appeal.

given to the hearing officer by appellant's attorney at the Franchise Tax Board hearing, and from information found in appellant's Superior Court Probation Report. Respondent's hearing officer listed all the drug sales recorded on the "ledger" sheets seized at the time of his arrest using only the figures on the records as they appeared without changing the decimal points to reflect higher amounts. (Resp. Ex. Y) The hearing officer also concluded, based upon appellant's admission in his probation report, that appellant had personally consumed one gram of cocaine per day at a value of $110 dollars per gram, for a total of $33,000 dollars during the assessment period. The cost per gram was corroborated by information received from the CRI and the price list provided by the Western States (Police) Information Network. When the amounts in appellant's ledger were added to this amount, appellant's resulting taxable income was determined to be $154,227 with a net tax liability of $15,682.[2/] This timely appeal followed.

On November 5, 1982, appellant entered a negotiated plea of guilty to a violation of section 11350 of the Health and Safety Code (possession of cocaine).

Appellant challenges the revised assessment on two grounds: first, because it includes an adjustment of $33,000 attributed to appellant's self-consumption of cocaine and he was not accorded a hearing relative to the nature of the quantity of his drug usage during the period in question and second, that the rescheduled assessment does not reflect subtotals or purchases of drugs which were listed on the scraps of paper seized from appellant.,

Appellant has conceded that he received income from the illegal sale of narcotics; therefore, respondent's

2/ The original tax liability, before any modification by the hearing officer, was $38,626 which included an adjustment for the cost of goods sold. This deduction is now prohibited by statute: therefore, the revised assessment did not include a cost of goods sold deduction. Effective September 14, 1982, Revenue and Taxation Code section 17297.5 provides that no deduction shall be allowed in cases where the income is derived from the sale of a controlled substance such as cocaine. Section 17297.5 is specifically made applicable with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise.

conclusion in this regard is reasonable. The second question is whether respondent properly reconstructed the amount of appellant's income from drug sales.

Both federal and state income tax regulations require each taxpayer to maintain such accounting records as will enable him to file a correct return. (Treas. Reg. § 1.446-1(a)(4); Former Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(4), repealer filed June 25, 1981 (Register 81, No. 26).) If the taxpayer does not maintain such records, the taxing agency is authorized to compute his income by whatever method will, in its judgment, clearly reflect income. (Rev, & Tax. Code, § 17561, subd. (b).) The existence of unreported income may be demonstrated by any practical method of proof that is available. (Davis v. United States, 226 F.2d 331 (6th Cir. 1955); Appeal of John and Codelle Perez, Cal. St. Bd. of Equal., Feb. 16, 1971.) Mathematical exactness is not required. (Harold E. Harbin, 40 T.C. 373, 377 (1963).) Furthermore, a reasonable reconstruction of income is presumed correct, and the taxpayer bears the burden of proving it erroneous. (Breland v. United States, 323 F.2d 492, 496 (5th Cir. 1963); Appeal of Marcel C. Robles, Cal. St. Bd. of Equal., June 28, 1979.) The presumption is rebutted, however, where the reconstruction is shown to be arbitrary and excessive or based on assumptions which are not supported by the evidence. (Shades Ridge Holding Co., Inc., ¶ 64,275 P-H Memo. T.C. (1964), affd. subnom., Fiorella v. Commissioner, 361 F.2d 326 (5th Cir. 1966).)

There are several accepted methods which respondent can utilize to reconstruct income in cases such as this. In computing appellant's taxable income, respondent used the sales method based solely on the amounts listed in appellant's "ledger". Given the information furnished by the CRI prior to appellant's arrest and by appellant's representative at the petition for reassessment hearing, it appears respondent reasonably relied upon the "ledger" as an accurate record of appellant's sales. (See Appeal of Mart Conrad Wende, Cal. St. Bd. of Equal., March 1, 1983.) However, respondent also determined that appellant self-consumed approximately one gram of cocaine a day, valued at $110 per gram, for the

period January 1, 1981, to October 31, 1981.3/ Inclusion of an amount attributable to personal consumption is not reasonable when the sales method of reconstructing income is, used because the amount of sales, as opposed'to purchases, would not be affected by personal consumption. An amount for self-consumption is generally employed when the net worth method of reconstruction of income is used where the taxpayer's living expenses, including any drug use, are computed. (See Llorente v. Commissioner, 649 F.2d 152 (2nd Cir. 1981).) We must therefore modify respondent's assessment to exclude the $33,000 in income attributed to appellant's self-consumption of drugs.

Appellant makes several other assertions in an attempt to undermine respondent's reconstruction of income for the period in question. We do not find them persuasive. Again, we emphasize the fact that when the taxpayer fails to comply with the law in supplying the required information to accurately compute income and respondent finds it necessary to reconstruct taxpayer's income, some reasonable basis must be used. Respondent must resort to various sources of information to determine such income and the resulting tax liability. In such circumstances, the reasonable reconstruction of income will be presumed correct, and the taxpayer has the burden of disproving such computation even though crude. (Agnellino v. Commissioner, 302 F.2d 797 (3d Cir. 1962); Merritt v. Commissioner, 301 F.2d 484 (5th Cir. 1962).) Mere assertions by the taxpayer are not enough to overcome that presumption. (Pinder v. United States, 330 F.2d 119 (5th Cir. 1964).)

After reviewing the entire record, we conclude that appellant received unreported taxable income from

3/ The actual assessment is dated January 1, 1981, to October 31, 1981. The latter date is erroneous and 'should be October 30, the date of appellant's arrest. Additionally, we note that there appears to be no basis for respondent's choice of January 1, 1981, as the starting date for appellant's involvement in drug sales and usage. No evidence was presented which would reasonably lead to such a conclusion. In any event, because of our conclusion that the amount of drugs which were self-consumed should not be included in appellant's income, and our acceptance of the sales method of reconstruction of income as proper, the dates used by respondent do not affect the outcome of this appeal.

illegal drug sales for the period in question and that respondent's jeopardy assessment should be sustained as modified in accordance with this opinion.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of David Wayne Dominici for reassessment of a jeopardy assessment of personal income tax in the amount of $15,682 for the period January 1, 1981, through October 31, 1981, be and is the same hereby modified in accordance with this opinion. In all other respects, the action of the Franchise Tax Board is sustained..

Done at Sacramento, California, this 13th day of December, 1984, by the State Board of Equalization, with Board Members Mr.Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9